

# SFC's statement on regulatory framework for virtual asset portfolio managers, fund distributors and trading platform operators

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The Hong Kong Securities and Futures Commission (SFC) has hitherto taken the position that under the existing scope of Hong Kong regulation, the market for virtual assets<sup>1</sup> may not be subject to the oversight of the SFC if the virtual assets involved fall outside the legal definition of “securities” or “future contracts”.

The SFC has responded to the growing investor interest in gaining exposure to virtual assets via funds and unlicensed trading platform operators in Hong Kong by releasing a statement on 1 November 2018 clarifying the regulatory framework for virtual asset portfolio managers, fund distributors and trading platform operators. The SFC has indicated it will adopt an approach which will bring a significant portion of virtual asset portfolio management activities into its regulatory supervision. It has also set out a conceptual framework which (if implemented) could provide a path for virtual asset trading platform operators that are willing to adhere to a high level of standards and practices to voluntarily submit themselves to regulation by the SFC, thereby setting them apart from those operators which do not seek to be supervised by the SFC.

In setting out its new approach, the SFC has referred to the following risks posed by virtual assets:



To better exercise investor protection in its application of regulatory power, the SFC has announced the below steps:

- Regulatory approach for virtual asset portfolio managers and fund distributors**

The SFC has decided to include a significant portion of virtual asset portfolio management activities into its regulatory scope via the licence activities and regulatory standards. The targeted scope includes mainly virtual asset portfolio managers and virtual asset fund distributors.
- Exploring regulation of platform operators**

The SFC has developed a conceptual framework for the potential regulation of virtual asset trading platforms to explore a regulatory approach regarding the international developments on virtual asset trading, and to provide a path for compliance for capable platform operators that are willing to adhere to a high level of standards and practices.

<sup>1</sup> Virtual Assets include digital tokens, digital currencies, security or asset-backed tokens, virtual commodities and crypto assets.

# Highlights of the regulatory framework

In light of the SFC's statement, virtual asset portfolios managers, fund distributors and trading platform operators need to understand the SFC's new regulatory approach to virtual assets, how they will be impacted and what potential changes they will need to make to their existing business model.

## The SFC regulatory framework at a glance

Target participants	Focus areas	Key impacts
Virtual asset portfolio managers	Scope of supervision	<ul style="list-style-type: none"> <li>Firms managing funds which solely invest in virtual assets and distribute in Hong Kong (Type 1 regulated activity)</li> <li>Firms which are licensed or are to be licensed for Type 9 regulated activity</li> </ul>
	Licence type	<ul style="list-style-type: none"> <li>Type 1 regulated activity (dealing in securities) for distributing funds in Hong Kong that partially or wholly include virtual assets</li> <li>Type 9 regulated activity (asset management)</li> </ul>
	Regulatory reference	<ul style="list-style-type: none"> <li>"Regulatory standards for licensed corporations managing virtual asset portfolios"</li> <li>"Circular to intermediaries on the distribution of virtual asset funds"</li> </ul>
	Licensing process	<ul style="list-style-type: none"> <li>The SFC expects to be fully informed by both licence applicants and licensed corporations in respect of their current or planned virtual asset management activities</li> <li>The abovementioned fund management is subject to the SFC's regulation via the imposition of licensing conditions</li> </ul>
Virtual asset fund distributors	Scope of supervision	<ul style="list-style-type: none"> <li>Firms which distribute funds invest in virtual assets in Hong Kong</li> </ul>
	Licence type	<ul style="list-style-type: none"> <li>Type 1 regulated activity (dealing in securities) for distributing funds in Hong Kong that partially or wholly include virtual assets</li> </ul>
	Regulatory reference	<ul style="list-style-type: none"> <li>"Circular to intermediaries on the distribution of virtual asset funds"</li> </ul>
Virtual asset trading platform operators	Scope of Conceptual Framework	<ul style="list-style-type: none"> <li>Opt-in approach designed to set those platform operators who are committed to adhering to the SFC's high standards apart from those platform operators who are unable or unwilling to meet the conduct standards set by the SFC</li> </ul>
	Approach	<ul style="list-style-type: none"> <li>Discussion with platform operators regarding the SFC's expected regulatory standards</li> <li>Observation of the live operation of the platform via the SFC Regulatory Sandbox</li> <li>Compliance with key terms and conditions including financial soundness, insurance requirements, knowledge assessment, anti-money laundering and counter-financing of terrorism, disclosure requirements, trading rules, surveillance requirements, client asset segregation requirements and ongoing reporting obligations.</li> </ul>



## How KPMG can help

KPMG can advise impacted market participants on the application of these new regulatory requirements:

### Advisory assistance in SFC licence applications

- Assist you in the preparation of the application pack, including reviewing application forms along with the other application documents
- Provide guidance and support throughout the application process

### Process review and gap analysis

- Assist you in assessing in-scope processes and controls
- Provide a list of gaps with recommendations and professional remediation support to address the identified gaps in an efficient and cost-effective manner

### Compliance assessment

- Assist you in reviewing major policies and relevant compliance programmes applicable to your business operation and regulated activities
- Provide professional advice and support on compliance programme and policy enhancement

# Cybersecurity is at the front and centre for virtual assets

The SFC noted that “Cyber-attacks resulting in the hacking of virtual asset trading platforms and thefts of virtual assets are common”, and that “virtual asset funds face a unique challenge due to the limited availability of qualified custodian solutions.”

Given the potentially high value of virtual assets and the natively digital nature, trading platform operators and portfolio managers and their customers are prime targets for cyber criminals. If hackers breach virtual asset crypto infrastructure, they can transfer virtual assets out to external addresses, leaving platform operators and portfolio managers with little or no recourse.

Analysing cyber incidents impacting the crypto exchange in the past few years, the attack vectors and root causes span a wide spectrum. Examples include administrator accounts being compromised, server failure due to DDOS, unencrypted data stores, phishing attacks, smart contract bugs, software vulnerabilities, order sequencing issues, security update failure and poor wallet tiering, most of which are not new or unique in the virtual asset space. It is clear from these that lessons learned from decades of security and risk management experience with other traditional and emerging technologies are still applicable.

There is a need for crypto-specific security standards that complement existing security frameworks such as those published by NIST or ISO. While some efforts are underway across the industry, these are still under development and some leading industry approaches are already emerging. These include:



## How KPMG can help

Cyber Risk	IT Operations	Tax advisory & crypto audit
<ul style="list-style-type: none"><li>• KPMG can assist you in assessing your cyber and IT risk strategy for your virtual asset platforms</li><li>• KPMG can help you to clarify your approach for mitigating common threats, linking this to your strategy to protect the virtual assets</li></ul>	<ul style="list-style-type: none"><li>• KPMG can assist you in reviewing your IT operating model to determine whether it reflects both your business objectives as well as your regulatory obligations</li></ul>	<ul style="list-style-type: none"><li>• KPMG can advise you on the tax implications of virtual asset related activity</li><li>• KPMG has developed audit capability for certain virtual assets including a crypto currency audit platform</li></ul>

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